

Tax Supported
New Issue

State of Vermont

Rating

General Obligation Bonds AA+

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New Issue Details

\$30,000,000 General Obligation Refunding Bonds, 2005 Series D, are scheduled for competitive bids on Nov 15. Bonds will be due July 15, 2006–2025 and are callable on or after July 15, 2015 at par.

Security: The bonds are general obligations of the State of Vermont, with its full faith and credit pledged.

■ Outlook

Vermont's conservative approach to debt and financial operations provides a strong foundation for its high credit quality. During the protracted recession period of the early 1990s, the state assiduously followed an austere recovery program, demonstrating well its willingness to take appropriate action for stability. Following recovery, its reserves were fully funded, expenditure levels remained under control, and substantial surplus was used for capital purposes, allowing debt to decline. The state's economy weakened in 2001–2002, and revenues were below projections. Appropriations were cut, but partial use of the reserve was still necessary. Operations subsequently have been favorable, and reserves fully rebuilt.

■ Rating Considerations

Important to Vermont's long-term credit assessment is the demonstrated willingness to keep debt within manageable parameters and fidelity to the simplicity of debt structure, having used faith and credit obligations almost exclusively. Virtually all direct debt remains general obligation, and amortization is rapid. In line with affordability recommendations, annual borrowing has been reduced, and considerable capital needs have been met from cash, not bonding. Net tax-supported debt has declined 18% since 1997, and debt ratios are moderate.

Financial operations were successful for the six years through 2001. After elimination of the deficit in fiscal 1996, the rebuilding of the budget stabilization reserve commenced, followed by the establishment of further reserves for education and welfare as well as the use of current surplus for capital purposes. Reserves became fully funded at 5% of revenues. Revenues, driven by the personal income tax, consistently exceeded estimates until weakness surfaced in 2001, forcing use of over half of the reserves by fiscal 2002. In fiscal 2003, revenues recovered to meet estimates, and in both fiscal years 2004 and 2005, surging revenues allowed for sizable surpluses and full replenishment of reserves. Through October 2005, fiscal 2006 revenues are on track with estimates.

Vermont lost nearly 5% of employment in the early 1990s recession, but by 1994, employment exceeded the pre-recession level. However, manufacturing employment, higher paying than the services sector, was slower to recover. Manufacturing again suffered from 2000–2003, falling 19% before stabilizing in 2004. This loss was offset by resiliency in other sectors, and total employment was virtually unchanged from 2000–2003 before resuming growth during 2004 with a 1.3% job gain. Through September 2005, employment was up 1.5% over the previous year. Per capita personal income growth climbed from 91% of the U.S. level in 1997 to 97% in 2004.

November 11, 2005

■ Strengths

- Virtually exclusive use of general obligation debt.
- Moderate and declining debt ratios, with affordability planning.
- Generally conservative financial policies.
- Reserves fully funded.

■ Risks

- Some vulnerability due to importance of the manufacturing sector.
- Rapidly growing Medicaid and education expenditures constrain future budgets.

■ Debt Position

Vermont has an increasingly favorable debt position, and debt levels have consistently declined, with reduced issuance recommendations from the debt affordability advisory committee. Net tax-supported debt of \$470 million is 18% below that of 1997, which has driven ratios down to \$757 per capita and 2.5% of personal income, well below the 1997 levels of \$987 per capita and 4.4% of personal income.

There are no constitutional or statutory restrictions on debt in Vermont. All direct debt is now general obligation, as a minor amount of leases and certificates of participation (COPs) was refunded in 1998. The bonds, which refunded the leases and COPs, are treated as special fund bonds for internal cost accounting purposes but are actually general purpose obligations. General purpose bonds are serviced from the general fund and highway debt from the transportation fund. Not included in the general obligation debt is debt issued by the Education and Health Building Finance Agency for the benefit of developmental and mental health services providers, although much support for the programs comes from state appropriations.

There is considerable exposure through credit extension, although it was significantly reduced with the sale of the portfolio of the Vermont Home Mortgage Board, which had liabilities of \$117 million in 1998. The state's full faith and credit back up certain programs of the Vermont Economic Development Authority (VEDA), including the authority to insure up to \$15 million in mortgages, and the authority is authorized to reimburse lenders participating in the Financial Access Program to a maximum of \$2 million. Mortgages amounted to \$8.5 million, and the reimbursement liability was about \$870,000 million. VEDA has issued commercial paper (\$53.7 million outstanding) for financing new loans; the commercial paper program has a reserve deficiency

makeup provision with the state, not to exceed \$55 million. Calls on the various guarantees have been minor. There are reserve fund deficiency makeup provisions with the state's municipal bond bank and the housing finance agency, with the latter limited to \$125 million in bonds; no calls have been made through this provision.

Short-term debt has been employed regularly, both for operating and capital purposes. In 1993–1997, it was entirely in the form of commercial paper. Subsequently, there was then no need for operating borrowing until fiscal 2003 when \$75 million was issued. In fiscal 2004, \$48 million was issued, but the state's finances have improved since then, with no short-term borrowing needed.

Vermont has a capital debt affordability advisory committee that will recommend prudent debt authorizations, taking into account, among other things, debt in relation to personal income and debt service in relation to revenues. Annual amounts declined from \$64 million in fiscal 1994 to \$43 million in 1997 and 1998 and to under \$40 million in each year from 1999–2004. The recommendation rose to \$41 million in fiscal 2005 and \$45 million in 2006 and 2007. Authorizations have approximately matched recommendations, although surpluses were used to reduce bonding in fiscal years 2000 and 2001.

The state will follow this issue with \$15 million of general obligation Vermont citizen bonds in December. The state now makes annual bond authorizations, eliminating any overhang of authorized but unissued debt.

■ Financial Operations

The general fund is the basic operating account. Accounting has been done on a cash basis, but the conversion to generally accepted accounting principles (GAAP) was completed for the 1996 fiscal year. Vermont's comprehensive annual financial reports (CAFRs) for fiscal years 2002, 2003, and 2004 were each delayed due to complications of a new financial system, conversion to GAAP Statement No. 34, and a delay in auditing capital assets. The state believes the problems have been remedied, and the fiscal 2005 CAFR is expected to be issued in December.

Vermont has a diverse revenue stream, including a personal income tax, which provided for 20.1% of audited fiscal 2004 total own-source revenues. The income tax was decoupled from the federal income tax in tax year 2001. Vermont's 6% sales tax — which yields 12.5% of revenues — exempts food, medicine,

clothing, and supplies and energy for manufacturing and agricultural uses. Vermont also has a corporate income tax, an insurance tax, property transfer tax, an estate tax, liquor and cigarette taxes, and a statewide property tax for education, which was 23.2% of revenues.

After a difficult period, Vermont returned to surplus operations in fiscal 1996, which, when combined with a transfer from the transportation fund, eliminated the general fund deficit from the previous year. During fiscal 1997, revenues well exceeded estimates, and a major reserve fund deposit was made. At June 30, 1997, the budget stabilization fund had a balance of \$35.1 million, \$7 million was in reserve for education and \$2.9 million was reserved for debt reduction. The transportation fund held \$7 million in its reserve.

Financial operations in the following years were favorable, with revenues generally ahead of estimates, operating surpluses achieved, and reserves fully funded at 5% of revenues. Additionally, significant appropriations were made for capital and other one-time purposes. In fiscal 2001, growth slowed, but an operating surplus of \$36 million was achieved. Cigarette taxes, which totaled \$11 million in the previous year, began to flow to the health care access trust fund instead of the general fund.

The fiscal 2002 budget assumed that available revenue would be around the same level as in the previous year, and the operating surplus after transfers of \$23 million to the transportation and education funds was set at \$9.3 million. In fact, general fund revenues were about 7% lower than in 2001 and 10% below original estimates. The personal income tax was 11% below the previous year and 13% below original estimates. Revenue estimates were lowered twice during the year, and in response, appropriations were reduced; however, the final shortfall dictated the use of \$29 million from the reserve, leaving \$17 million in that fund. On a GAAP basis, the general fund ran a \$23 million operating deficit, to close with a \$149.6 million total fund balance.

Fiscal 2003 revenue estimates were lowered, and the gap was to be met from transfers and cuts. However, following late year strength, revenues actually matched the original level, and in essence, the transfers were added to reserves. Taxes for the year rose 3.1%, reflecting strength in insurance and estate taxes, while the personal income tax was up only 0.9% and the sales tax, 1.8%. At the close of the year, the general fund stabilization reserve was about one-half funded at \$23.5 million, and the transportation reserve held \$9.2 million. A caseload

General and Special Revenue Funds

(\$000, GAAP)

	2001-2002	2002-2003	2003-2004
Revenues	2,804,565	2,913,367	3,296,227
Taxes	1,600,725	1,615,244	1,831,298
Federal Aid	964,141	1,036,188	1,195,394
Expenditures	2,894,940	3,055,008	3,213,100
Education	1,035,570	1,090,652	1,132,649
Human Services	1,065,880	1,202,966	1,299,899
Transportation	311,133	284,978	289,728
Debt Service	69,214	73,213	70,833
Operating Result	(17,840)	(88,109)	147,312
General Fund Balance	149,594	99,752	154,725
Undesignated Balance	97,898	47,061	61,974

GAAP – Generally accepted accounting principles.

reserve amounted to \$17.2 million. The education fund drew on its reserve, bringing it down to \$11.2 million. On a GAAP basis, the general fund ran a \$49.8 million operating deficit and closed with a \$99.8 million fund balance.

The fiscal 2004 budget expected moderate revenue growth. Actual growth was 4.5% for the income tax and 17.0% for the sales tax (inclusive of a rate increase). The state also applied \$50 million in one-time federal aid plus \$32.9 million in enhanced Medicaid support, which allowed it to bolster various reserve accounts and make one-time expenditures. The state closed fiscal 2004 with a \$57 million general fund surplus, which was reduced by year-end transfers to the transportation fund, teacher's retirement, the caseload reserve, and other funds. The state also transferred \$20.9 million to fully fund the stabilization reserve and carried forward a \$15.6 million surplus. The state also realized surpluses in both the transportation and education funds, which allowed full funding of the reserves for those accounts, and a \$14.9 million surplus was carried forward in the education fund. On a GAAP basis, the general fund incurred a \$54.9 million operating surplus and a total fund balance of \$154.7 million.

Fiscal 2005 revenue estimates, originally set at \$922.6 million in January 2004, were raised to \$950 million in July and \$981.3 million in January; the total general fund revenues ultimately amounted to \$1.04 billion, or 8.9% over fiscal 2004's, with the overage due largely to personal income tax receipts, which was up 16.4%, and corporate income tax receipts, up 34%. A \$54 million operating surplus was used for a \$21 million transfer to the health access trust fund and smaller transfers, including the teacher's retirement fund and the transportation fund, leaving a \$19.6 million carryover.

The enacted fiscal 2006 general fund budget was based on \$1.015 billion general fund revenues, later

increased to \$1.06 billion. Through October 2005, the general fund was up 10% over last year and ahead of estimates. Revenue growth was led by stronger than expected corporate tax receipts; personal income tax receipts are slightly below estimates.

Education fund spending was up sharply in fiscal 2005 as the result of Act 68, which increased the state's share of K-12 education spending and lowered local property taxes. The sales tax was raised from 5% to 6% on Oct. 1, 2003, and effective July 1, 2004, one-third of all sales tax receipts are allocated to the education fund, with the remainder retained in the general fund. The act also splits the statewide property tax rate, with homestead property taxed at a rate equal to about two-thirds of the nonresidential rate, which takes advantage of the significant and increasing number of out-of-state second home owners in Vermont.

The transportation and education funds are important in state operations. Transportation revenues have been sluggish, with revenues to date down 1.3% from last year. The education fund relies on the allocation of the sales tax, the statewide property tax, lottery proceeds, and motor vehicle purchase and use tax receipts. Operations of the fund have often relied on use of its reserve, now also fully funded.

Vermont's pension systems are strong. The State Employees Retirement System was 97.8% funded at the last actuarial valuation on June 30, 2005. The Vermont State Teacher's Retirement System was 90.7% funded. The state has funded the teacher's system below the actuarially recommended contribution; however, it added a portion of both the fiscal years 2004 and 2005 surplus.

■ Economic Base

Vermont has a small but increasingly prosperous economy that includes manufacturing, tourism, agriculture, and health and educational services. Health and education services now account for nearly 18% of employment, and leisure and hospitality make up nearly 11%, both well above the national average. Educational services alone are 4.2% of Vermont's jobs, nearly twice the national share. The business and professional services sector is small here, making up just 7.2% of state jobs compared with 12.5% for the nation.

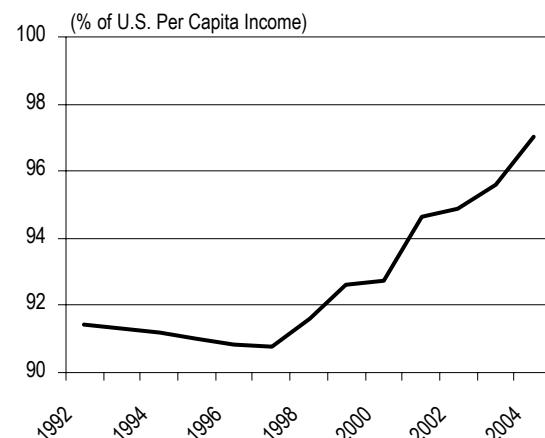
Manufacturing, mostly durables, is still important at 12.1% of jobs, above the national rate of 10.9%. Manufacturing declined in the 1990s recession, with employment dropping from over 50,000 in 1985 to the 43,000 level in the early 1990s. There was

recovery, with 2000 manufacturing employment at 46,400, but it slipped by 2003 to 37,600 and has stabilized near that level. The state's largest private employer continues to be IBM, which reduced its work force, primarily in the Burlington area, by some 1,800 employees during the recession, although it has added back some employees. General Electric also has a significant manufacturing facility in Rutland. Tourism is broad based, including several ski areas for winter attraction, while the scenic beauty and countryside encourage summer and fall visitors. Several ski areas have undergone improvement, including a continuation of year-round use. Increasing second home and condominium usage provides some stability and has driven a surge in housing prices. Canadian tourism and shopping are an economic factor.

Employment in Vermont peaked in 1989 after a period of rapid growth. Nearly 5% of employment was lost, only about half as severe as the losses in most New England states. By the end of 1994, the loss had been regained, and 2001 annual employment was more than 15% over the earlier peak.

Vermont's employment growth has outperformed the nation's during each year of the current decade, as it rose 1.1% during 2001 and then lost a combined total of 0.9% in 2002 and 2003. Job growth returned to Vermont in 2004, with a 1.3% increase, which both exceeded the national average and recouped the entire recessionary loss. Through September 2005, Vermont gained 1.5% jobs over the previous September, led by

Vermont Per Capita Income
(Years Ended Dec. 31)



a 5.6% increase in construction and a 3.7% gain in professional and business services. Unemployment is consistently among the lowest in the nation.

Vermont's personal income per capita has lagged the U.S. rate since World War II, falling to as low as 77% of the U.S.'s in 1950, and it hovered at only 83% as recently as 1977. In more recent times, per capita personal income hovered around 90% of the U.S. average until 1998, when it began a string of seven straight years of growth ahead of the nation. Revised 2004 per capita personal income of \$32,063 was 97% of the U.S. rate, a modern record high and ranking the state 23rd among the states. However, Vermont remains less wealthy than neighboring New Hampshire, where a

faster-growing economy and the influence of the Boston metropolitan region drove per capita personal income to 111% of the U.S. rate in 2004.

Vermont's population grew 8.2% during the 1990s, faster than the New England region, yet slower than the U.S. The census bureau estimates Vermont has grown about 0.5% per year during this decade, about as fast as New England but slower than the U.S. Vermont's population is well-educated, with nearly one-third of adult Vermonters holding college degrees, ranking ninth of the 50 states. Vermont also has the nation's largest share of population — nearly three-quarters — living outside the state's primary metropolitan area.

Economic Trends

Nonfarm Employment

(000, Not Seasonally Adjusted)

	Vermont	% Change	U.S.	% Change
1989	262	—	108,014	—
1990	258	(1.6)	109,487	1.4
1991	249	(3.3)	108,374	(1.0)
1992	251	0.8	108,726	0.3
1993	257	2.5	110,844	1.9
1994	264	2.5	114,291	3.1
1995	270	2.4	117,298	2.6
1996	275	1.8	119,708	2.1
1997	279	1.6	122,776	2.6
1998	285	2.0	125,930	2.6
1999	292	2.3	128,993	2.4
2000	299	2.4	131,785	2.2
2001	302	1.1	131,826	0.0
2002	299	(0.9)	130,341	(1.1)
2003	299	0.0	129,999	(0.3)
2004	303	1.3	131,480	1.1
Sept. 2004	306	—	132,127	—
Sept. 2005p	311	1.5	134,325	1.7

Unemployment Rates

(%, Not Seasonally Adjusted Annual Rates)

	Vermont	U.S.	State as % of U.S.
1989	3.6	5.3	68
1990	4.9	5.6	88
1991	6.6	6.8	97
1992	6.4	7.5	85
1993	5.3	6.9	77
1994	4.6	6.1	75
1995	4.3	5.6	77
1996	4.4	5.4	81
1997	4.0	4.9	82
1998	3.1	4.5	69
1999	2.9	4.2	69
2000	2.6	4.0	65
2001	3.3	4.7	70
2002	4.0	5.8	69
2003	4.5	6.0	75
2004	3.7	5.5	67
Sept. 2004	3.5	5.4	65
Sept. 2005p	3.7	5.1	73

Personal Income

(Change from Prior Year)

% Change

	Vermont	U.S.	State Growth as % of U.S.
1990	4.3	6.4	67
1991	1.3	3.5	37
1992	6.8	6.3	108
1993	3.1	3.7	83
1994	4.9	5.2	95
1995	4.8	5.3	89
1996	5.4	6.0	90
1997	6.9	6.1	114
1998	6.1	7.4	83
1999	5.8	5.1	114
2000	7.9	8.0	98
2001	5.1	3.5	145
2002	1.6	1.8	91
2003	3.4	3.2	107
2004	5.8	6.0	97

Personal Income Per Capita

(Change from Prior Year)

% Change

	Vermont	U.S.	State Growth as % of U.S.
1990	2.9	5.2	57
1991	0.6	2.1	29
1992	6.0	4.8	124
1993	2.2	2.4	93
1994	3.8	3.9	98
1995	3.8	4.1	94
1996	4.6	4.8	96
1997	4.7	4.8	99
1998	7.1	6.1	116
1999	5.1	3.9	129
2000	7.0	6.8	102
2001	4.6	2.4	187
2002	1.0	0.8	133
2003	2.9	2.2	134
2004	6.5	4.9	132

Components of Personal Income: Earnings

(%)

	Vermont			U.S.		
	2002	2004	% Change	2002	2004	% Change
Construction	7	8	23	6	6	12
Manufacturing	18	16	(1)	14	13	5
Durable Goods Manufacturing	13	12	(2)	9	8	5
Trade, Transportation, and Utilities	17	17	10	16	16	9
Financial Activities	6	6	14	10	10	15
Professional and Business Services	9	9	14	15	15	10
Education and Health Services	15	15	13	10	11	13
Government and						
Government Enterprises	17	18	16	16	17	12
Total Nonfarm Earnings	—	—	11	—	—	10

State Population: 608,827 (2000 Census); 621,394 (2004 Census Bureau Estimate).

Population Change: 1990–2000 U.S. 13.1%, State 8.2%; 2000–2004 U.S. 4.3%, State 2.1%.

Personal Income Per Capita 2004p: \$32,063, 97% of U.S., rank 23rd.

p – Preliminary.

Note: Monthly unemployment rates are seasonally adjusted.

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